CREDIT RATING AGENCY

BULGARIA
95, Evlogi Georgiev blvd.
1142 Sofia
Tel. (+359 2) 9876363
www.bcra-bg.com

FYR of Macedonia

September 2015

Nikoleta Koleva, Lead Economic Analyst
n.koleva@bcra-bg.com

Dr. Kiril Grigorov, Financial Analyst
grigorov@bcra-bg.com

Ventceslav Petrov, Financial Analyst
v.petrov@bcra-bg.com

SOVEREIGN RATING	Initial rating 14.09.2015
Long-term rating:	BB- (ns)
Outlook:	Stable
Short-term rating:	B (ns)

● (ns) – not solicited rating

***BCRA – CREDIT RATING AGENCY AD (BCRA)** is the third fully recognized rating agency in the EU, registered pursuant to Regulation No. 1060/2009 of the European Parliament and of the Council. The credit ratings, assigned by the BCRA are valid throughout the EU and are fully equal to those, of the other agencies, recognized by the European Securities and Markets Authorities, without any territorial or other limitations.*

"BCRA - CREDIT RATING AGENCY" AD rates the FYR of Macedonia with unsolicited sovereign long-term rating BB- (ns) and short-term B (ns) with stable outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (http://www.bcra-bg.com/files/file_330.pdf).

The report has been prepared and the rating – assigned, based on public information, made available by the National Bank of the Republic of Macedonia, the State Statistical Office, the Ministry of Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however it cannot guarantee the accuracy, adequacy and completeness of the information used.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

The political situation in the FYR of Macedonia in recent years is unstable, problems stemming from severe conflicts between the ruling party, the Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE), and the opposition, SDSM (Social Democratic Union of Macedonia). The political crisis escalates in the past year (2014-2015) as a result from an announcement of large-scale illegal telephone tapping by the ruling party of various politicians, governmental officials, etc. The opposition announced that it held more than 20 000 records proving serious violations by VMRO-DPMNE and would periodically release some of them by different media to the public, whereas against the opposition's leader accusations are raised for espionage carried out by foreign services and attempted coup d'état by the political party. Also, the released recordings of the illegal tapping reveal severe violations against the rule of law and democracy, deep structural problems in the country, complete amalgamation between the state and the governing party, dependencies and political assignments in the judicial system, almost complete absence of independent media, corruption, conflict of interests etc.

For the moment (of the report) there is somewhat of a cool-down in the conflicts between the parties, reached by determining a date for the next early elections (in 24 April 2016). However, the country is still in dire position with respect to its political state. The difficulties in reaching a compromise between the ruling party and the opposition as well as the reliance on arbitration by foreign organizations clearly show the absence of sustainable mechanisms and will among the political elite, along with underdeveloped democratic culture. These negative factors hinder FYR of Macedonia's economic development and further jeopardize its perspective for European integration, reinforced by the increasing distrust among European partners.

There is also a danger of possible ethnic and/or religious clashes between the majorities and the minorities in the country, and also the dispute between Greece and FYR of Macedonia over the name of the country has not yet been resolved as well as the Good-neighbour Agreement with Bulgaria is still to be signed. The complicated international situation also affects the current Government, mainly due to the fact that the FYR of Macedonia is situated on one of the main routes of the refugees from Syria to Central Europe. At present there are some indications of Macedonians combating on the side of the radical Islamic groups in Syria and Iraq. Separatist inclinations in certain regions (predominantly populated by ethnical Albanians) further boost the nationalistic and xenophobic attitudes and destabilize the political system even more.

FYR of Macedonia's government is in a deep crisis and the perspectives for overcoming it are trifling. The early elections are not expected to lead to any changes in the Government structures – MP Nikola Gruevski is expected to return to power, which may result in further aggravation of the international insulation. If the stated development proves right, FYR of Macedonia will lose more of its perspectives for integration in the EU and NATO. In the medium term, the FYR of Macedonia cannot be expected to undertake rapid and serious reforms and accomplish some impending changes in the political sector and the economy.

FYR of Macedonia's economy is characterised by a high growth rate throughout the years, as typical for a developing country of small scale, and stable economic activity that remains less affected by the 2008-crisis and subsequent slow-downs compared other European countries' economies.

Excluding the years for which the FYR of Macedonia has reported decrease in economic activity (2009 and 2012), throughout the period 2007 – March 2015 the real annual growth rate is no less than 2.3%, with its highest level being reported in 2014 (of about 3.8%) for the years after the financial crisis. For the first quarter of 2015 FYR of Macedonia's GDP continued to increase steadily.

The sector group Wholesale and retail; Transportation and storage; Accommodation and food service activities[1], has the biggest share in the gross value added of the country, followed by Public administration; Education; Human health[2] and Real estate activities but the sectors that have contributed the most in the growth in the economy in the last year (2014) are Wholesale and retail; Transportation and storage; Accommodation and food service activities and Manufacturing. The growth in the economy is mostly export-led, since

[1] Wholesale and retail trade and repair of motor vehicles and motorcycles; Transportation and storage; Accommodation and food service activities

[2] Public administration and defence and compulsory social security; Education; Human health and social work activities

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

the volume of the country's export comes up to 48% of GDP (for 2014). In recent years the share of high value-added products (like Industrial machinery[3], Electrical machinery[4] and Road vehicles) in the country's exports expands, indicating an increase in the country's competitiveness in such goods.

The share of imports, on the other hand, remains higher than the country's exports (at around 65% of GDP in 2014), tending for the persistent deficit in the trade balance. It consists mainly of Manufactured goods classified chiefly by material used for the production of most exported products, indicating a certain dependency on foreign resources for its economic activities.

Investors' interest in FYR of Macedonia also shows signs of increasing in the last 2 years. The attractiveness to foreign investors of the country's investment conditions and perspectives has grown in recent years as verified by their intensified activity during 2013 and 2014 (FDI are around 3.3% of GDP), after the sharp drop in 2012 (FDI for the year are merely 1.5% of GDP). A large portion of the investment flows into the FYR of Macedonia in recent years originates from Switzerland, the Netherlands, Austria, Saint Vincent and the Grenadines, Turkey and Slovenia. The investment flow from Germany to the FYR of Macedonia exhibits a gradual increase after 2011, and similar development is also observed with respect to the UK – after a drop in 2012, its investments for the next years start to increase gradually. For the last year (2014) most of the investors' participation in FYR of Macedonia's economy is through debt instruments, and that tendency persists for the first quarter of 2015.

With respect to the country's labour market, it has recorded some improvements in recent years, bringing down the unemployment rate from 33.8% in 2008 to 28.0% in 2014. However, the indicator remains at alarmingly high levels. The youth unemployment is also at disadvantageous levels (over 51%) compared to the EU-average (between 22% and 24% for 2012-2014) and the long-term unemployment remains at above 80% of all registered unemployed persons. All these characteristics of the labour market in FYR of Macedonia represent risk factors for the condition and future development of the national economy and can be considered as a precondition for a higher risk of deterioration in production capacities and quality of the labour resource in the FYR of Macedonia.

There is also a large gap in the GDP-per-capita measure. The indicator for FYR of Macedonia remains much lower than the European Union (EU) average, and also ranks the country among the ones with the lowest income per capita in between its neighbouring countries on the Balkan Peninsula. Measured by purchasing power parity GDP per capita for FYR of Macedonia in 2014 is almost 3 times lower than the EU-average, whereas in nominal values the difference is even bigger – the income (in current prices in USD) for the FYR of Macedonia is merely 12-15% of the EU-average income.

The inflation (by the CPI measurement) in FYR of Macedonia decreases gradually after 2011 and in the second quarter of 2014 the country finds itself in a position of low deflation of 0.2% on a cumulative basis. Throughout the rest of the year the inflation remains almost unchanged, but shows some fluctuation during the first half of 2015 and eventually reaches -0.3% for June 2015.

The drop in prices in the FYR of Macedonia follows the general trend in other European countries. The deflation cannot be considered the result of poor economic decisions by the agents in the national economy, but rather it reflects the low economic activity in Europe in general and its effect over small open economies.

Two major groups of factors can be established that are responsible for the low price level in FYR Macedonia. The first group includes domestic factors of the FYR of Macedonia, with the main ones during 2014 being low prices of food and energy in the country. The negative effect of the energy prices contributing to the lower price levels became more prominent in December 2014. The other group of factors includes the low oil prices on the international markets since end-2014 (and thus – of the fuels and energy on the domestic markets) and the low price levels in FYR of Macedonia's trade partners[5]. The inflation[6] in the EU, measured by the HICP[7] drops from 3.1% in 2011 to 0.6% in 2014, and specifically in Germany (a major trade

[3] General industrial machinery and equipment, and machine parts.
[4] Electrical machinery, apparatus and appliances, and electrical parts thereof (including non-electrical counterparts, n.e.s., of electrical household-type equipment).
[5] Press release of the *National Bank of the Republic of Macedonia (NBRM)* from March 2015
[6] Data from *Eurostat*.
[7] Harmonized index of consumer prices.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

partner of the FYR of Macedonia) the inflation rate (according to HICP) decreases from 2.5% in 2011 to 0.8% in 2014.

The Government's activity performance represented by the budget balance and debt management signifies some deteriorations through both indicators in recent years. After 2010 the budget deficit grows from 2.4% of GDP (in 2010) to 4.2% in 2014 compared to an EU-average deficit of 2.4% of GDP for the same year (2014)[8]. The increasing differences between the budget categories is due to the faster growth in government expenditures in comparison to the growth in government revenues during 2011 and the subsequent years.

During the first half of 2015 the VAT revenues (which constitute for about 30% of all /central/ government revenues in 2014) underperform, and tend for the negative effects on budget revenues. The corporate tax, however, has increased due to the changes in the Corporate Tax Law in July 2014 and applied after 1 January 2015 and fully compensates for the aforesaid drop in revenues by the VAT-category. The government expenditures are another factor with negative repercussions due to their nature – most of them are in the form of social transfers (46.6% of all expenditures) as well as the wages and allowances costs (about 14% of all expenditures), both of which pose difficulties for the government if it attempts a decrease in the cost-category of the budget.

The country's indebtedness grows gradually after 2008, doubling in 2014 – from 23.0% of GDP (in 2008) to 46.0% of GDP (in 2014). The main driver of the increase is the growth in external public debt, but after 2011 the domestic public debt also stars gaining weight. The biggest increase in public debt occurs in the last year (2014), during which the Government issues Eurobonds on the international markets – the issued debt amounts to a total of EUR 500 million with a 7-year maturity. The acquired funds are intended to cover the budget deficit and partially – for the repayment of an outstanding debt. This also leads to an increase in the accumulated (foreign) reserves and ensures a higher confidence in the stability of the MKD/EUR exchange rate[9] by providing available resources.

On 27 February 2015 the FYR of Macedonia makes an early repayment of a debt to the IMF[10] of a total SDR 123.1 million[11] (approximately USD 173.3 million) and according to the Ministry of Finance, the repayment of this liability helped decrease the public debt by 1.7 p. p., and in June 2015 the public debt is at 43.7% of GDP.

Although it has been gradually growing since 2009, the public debt of FYR of Macedonia is still below the limit of 60% of GDP adopted by the EU, whereas the EU average of the ratio[12] for 2014 comes to 86.8% of GDP and 91.1% for the Eurozone. This ratio may be considered as a positive factor, but the continuous and quick increase in public debt is considered a negative development. Its growth may be a notice of a potential risk related to the (central) government's growing dependence on debt issuance as a method of financing its expenditures rather than provide for them with its collected revenues.

Another risk factor is the amount of the debt denominated in foreign currency. There has been little volatility of the MKD/EUR exchange rate since 2009, which is attributable to FYR of Macedonia's successful management of pegging its currency to the Euro. Also, the share of the debt denominated in currencies other than EUR and MKD has been decreasing since 2011 but still has a palpable presence thus providing a potential risk of future arising difficulties.

After 2010 the banks in the FYR of Macedonia preserve their high liquidity and good capitalization, keeping their capital adequacy well above the required 8%. The borrowed deposits by the banking system display a positive tendency, with a growing significance of the funds provided by individuals and households. The latter group (individuals and households) also participates more actively on the loan market in recent years, contributing for the growth of its smaller share out of all granted gross loans (from 38.4% in 2011 to 41.9% in June 2015), whereas the share of loans granted to corporate client moves in the opposite direction and falls below 60% in 2013.

The equity and reserves held by the banks also show a gradual increase through the years, along with the steady growth in the banking system's assets. The net profit in the sector also marks a significant increase after 2011 – by 166% till 2014.

[8] Data from *Eurostat*.

[9] In order to meet the requirements for maintenance and control of the exchange rate between the national currency and the Euro as per ERM II.

[10] IMF press-release.

[11] Special drawing rights.

[12] Data from *Eurostat*.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

The banking system of the FYR of Macedonia could be defined as stable. However, there is high concentration of foreign capital in this sector – Greek, Slovenian, French, Turkish, Bulgarian, German and Austrian banks account for about 76% of the banking system equity, and thus should be considered a potential risk factor, with possible negative effects stemming from spill-overs and possible contagion if troubles arise within their parent-organizations.

Outlook:

The stable outlook of the Sovereign Rating of the FYR of Macedonia reflects the BCRS's opinion that in the following years, despite the political situation and the upcoming early elections, there would not be any drastic changes in the country's general economic indicators and its credit worthiness.

BCRA would consider upgrading the Sovereign Rating and the Outlook for the FYR of Macedonia if there is improvement in the political situation of the country and shows progress in its international engagements. Other factors with a positive effect can be considered sustained economic growth, with little fluctuations, further improvement in the labour market conditions, improvement in the Government's budget structure and decrease in the deficit, and maintaining or lowering the country's indebtedness.

Negative pressures on the Sovereign Rating would be considered worsening in the situation of the banking system through spill-over effects from the Greece economy and possible contagion, worsening in the budget balance and continuing growth in the country's indebtedness, withdraw of investors from the country due to uncertain economic conditions and political instability.

Regulatory announcements

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

Summary of the minutes of the Rating Committee:

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the ***Model for grading and analysed*** in the ***Credit Rating Report*** according to the ***Sovereign Rating Methodology***. The members of the committee discussed the issues regarding the unstable political situation in the country and the upcoming early elections, which will be held in April 2016. Other factors that were discussed include the stable growth of the economy and the investors' higher interest in the country in the last 2 years. Risk factors were also considered, including mainly the persistent deficit in the trade balance, the gradually increasing public debt in recent years, and also the deterioration in the government budget. The banking sector is viewed as stable with high values in the indicators measuring liquidity and capital adequacy. However, there is a potential risk for the sector stemming from the predominant presence of foreign capital in the banking system.

The current initial sovereign rating and the related outlook have been determined based on the above discussion.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

Country	*Development classification*	*Probability of default indicator*
The FYR of Macedonia	*Emerging and Developing Europe (IMF classification)*	*CDS Market Indicator Not available.*

Indicators	Q1 2015	Q1 2014	2014	2013	2012	2011	2010	2009	2008	2007
GDP (in bn. MKD)	126.6	119.9	525.8	499.6	466.7	464.2	437.3	414.6	414.9	372.9
GDP real growth rates (in %) [2]	*3.2**	*3.3**	*3.8**	*2.7**	*-0.5*	*2.3*	*3.4*	*-0.4*	*5.5*	*6.5*
GDP (in bn. EUR)	2.1	1.9	8.5	8.1	7.6	7.5	7.1	6.8	6.8	6.1
Household final consumption	*1.4*	*1.4*	*6.0*	*5.8*	*5.6*	*5.6*	*5.4*	*5.2*	*5.3*	*4.7*
General government final consumption	*0.4*	*0.4*	*1.4*	*1.4*	*1.4*	*1.4*	*1.3*	*1.3*	*1.3*	*1.0*
Gross capital formation	*0.6*	*0.5*	*2.6*	*2.3*	*2.2*	*2.0*	*1.7*	*1.7*	*1.9*	*1.4*
Export of goods and services	*1.0*	*0.9*	*4.1*	*3.6*	*3.4*	*3.6*	*2.8*	*2.2*	*2.9*	*2.7*
Import of goods and services	*1.3*	*1.2*	*5.6*	*5.0*	*5.1*	*5.0*	*4.1*	*3.7*	*4.6*	*3.8*
GDP per capita (current LCU [3])	-	-	249,400	237,077	221,651	220,632	208,017	197,387	197,683	177,852
Total average monthly net wage (MKD)	21,444.7	21,091.7	21,394	21,146	20,903	20,848	20,554	19,958	16,095	14,586
Inflation - CPI (average, on cumulative basis, in %)	-0.9	0.6	-0.3	2.8	3.3	3.9	1.6	-0.8	8.3	2.3
Unemployment rate (in %, population aged 15+)	27.3	28.4	28.0	29.0	31.0	31.4	32.1	32.2	33.8	34.9
Average exchange rate MKD/EUR	61.55	61.65	61.62	61.58	61.53	61.53	61.51	61.27	61.27	61.18
Average exchange rate MKD/USD	54.59	45.00	46.44	46.40	47.90	44.23	46.46	44.08	41.86	44.72

in million EUR	Q1 2015	Q1 2014	2014	2013	2012	2011	2010	2009	2008	2007
Net export [6]	-313.5	-362.8	-1,471.1	-1,470.4	-1,628.2	-1,429.1	-1,301.1	-1,459.4	-1,701.1	-1,088.5
Trade balance [7]	-378.1	-426.1	-1,762.0	-1,748.1	-1,946.7	-1,838.0	-1,602.2	-1,699.8	-1,966.9	-1,356.5
Current account	-37.0	-126.8	-113.7	-146.8	-223.7	-189.2	-144.0	-457.1	-862.2	-421.2

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

Current account (as % of GDP)		*-1.8*	*-1.5*	*-1.3*	*-1.8*	*-2.9*	*-2.5*	*-2.0*	*-6.8*	*-12.7*	*-6.9*

	in billion EUR [1]	Q2 2015	Q2 2014	2014	2013	2012	2011	2010	2009
General government budget	**Revenues**	**1.50 [4]**	**1.32 [4]**	**2.54**	**2.45**	**2.43**	**2.39**	**2.30**	**2.22**
	Expenditures	**1.68 [4]**	**1.57 [4]**	**2.90**	**2.78**	**2.73**	**2.58**	**2.47**	**2.40**
	Budget balance	**-0.18 [4]**	**-0.25 [4]**	**-0.36**	**-0.33**	**-0.30**	**-0.19**	**-0.17**	**-0.18**
	Surplus | Deficit (as % of GDP)	-	-	*-4.2*	*-3.9*	*-3.8*	*-2.5*	*-2.4*	*-2.6*
General government debt	**Public debt**	**3.92**	**3.43**	**3.92**	**3.28**	**2.91**	**2.41**	**1.94**	**1.77**
	Public and guaranteed debt (as % of GDP), of which:	43.7	40.0	46.0	40.5	38.3	32.0	27.2	26.2
	Guaranteed debt (domestic and external) (% of GDP)	*7.6*	*7.2*	*7.7*	*6.3*	*4.7*	*4.3*	*3.2*	*2.6*
Gross external debt		**6.19 [5]**	**5.63 [5]**	**5.95**	**5.22**	**5.17**	**4.85**	**4.11**	**3.78**
as % of GDP		*68.7 [5]*	*66.0 [5]*	*69.8*	*64.3*	*68.2*	*64.2*	*57.8*	*55.9*
Gross foreign reserves (stock, end of period)		**2.25**	**1.87**	**2.44**	**1.99**	**2.19**	**2.07**	**1.71**	**1.60**
International investment position		**-4.82 [5]**	**-4.72 [5]**	**-4.78**	**-4.56**	**-4.18**	**-3.97**	**-3.63**	**-3.61**

[1] Values in EUR are calculated using the exchange rate for MKD/EUR for the corresponding period.
[2] Preliminary data for 2013 and 2014, and estimates for Q1 2015
[3] LCU - Local currency units
[4] The values are for the Central government budget for January-July 2015.
[5] The values are for Q1 2015.
[6] [Export - Import] (national statistics; in current prices); values in EUR are calculated using the exchange rate for MKD/EUR for the corresponding period.
[7] The data are in accordance with foreign trade statistics (from NBRM).